

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 16121
[Redacted]	)	
Petitioners.	)	DECISION
	)	
_____	)	

On July 26, 2001, the Income Tax Audit Division of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination to [Redacted] (taxpayers). In that Notice of Deficiency Determination the Audit Division denied a refund claim filed by the taxpayers for the 1997 through 1999 taxable years and asserted additional income taxes, negligence penalty, and interest in the amount of \$5,087 for the 1998 and 1999 taxable years. On October 31, 2001, the taxpayers filed a timely appeal and petition for redetermination. The taxpayers did not request an informal conference. The Tax Commission, having reviewed the file, hereby issues its decision.

**OPINION**

The primary issue in this administrative protest relates to amended Idaho individual income tax returns filed by [Redacted] for the 1997, 1998, and 1999 taxable years. On those amended returns the taxpayers claimed a pass-through loss from a partnership called [Redacted] that they purportedly formed in January 1997. Based on those amended returns, the taxpayers claimed a refund of \$16,634.

The refund claim was not immediately granted. Instead, the amended returns were sent to the Tax Commission's Income Tax Audit Division for review. After an initial review, it was determined that additional verification was needed before the returns would be accepted and the refund issued. An audit was then scheduled that encompassed not only the pass-through partnership loss claimed on the amended returns, but also certain itemized deductions and the

Idaho Medical Savings Account deduction that were claimed on the originally filed returns. An audit of [Redacted] was also scheduled.

In the audit engagement letters sent to [Redacted] and to [Redacted], the [Redacted] were asked to make available the books and records of the partnership as well as certain other requested documents. A date was set between the Tax Commission's auditor and the [Redacted] representative for review of the requested documents. However, on the date that had been set, the [Redacted] representative did not show up for the appointment. A few days later the [Redacted] representative called to arrange another date and time for the audit. The auditor declined to re-set the audit, and the Notice of Deficiency Determination that is the subject matter of this administrative protest was issued. Pursuant to that deficiency notice, the refund claimed for 1997, 1998, and 1999 was denied and the questioned itemized deductions and Idaho Medical Savings Account deduction claimed on the original 1998 and 1999 Idaho returns were disallowed. The 5% negligence penalty was imposed due to the failure of [Redacted] to provide the requested records at the scheduled audit.

The taxpayers have filed a timely protest and petition for redetermination. They have also submitted a copy of the [Redacted] partnership agreement; some computer-generated reports that purport to relate to [Redacted] but which in actuality appear to be a listing of all their personal expenditures during the years under review; and a box containing some cancelled checks, bank statements, and miscellaneous tax records. As discussed in greater detail below, after reviewing the materials provided by [Redacted], including the [Redacted] partnership tax returns, the Commission finds that [Redacted] is not engaged in any *bona fide* business and that the partnership returns, as well as the amended individual income tax returns filed by [Redacted], are fraudulent. As a result, [Redacted] claim for an Idaho income tax refund of \$16,634 is

denied. However, the tax deficiency asserted for the 1998 and 1999 taxable years relating to the disallowed itemized deductions and Idaho Medical Savings Account deduction will be modified to allow those deductions that the [Redacted] have now substantiated.

**1. Fraudulent Partnership Tax Returns.**

During the years at issue in this protest, [Redacted] was employed as a [Redacted]. [Redacted] was employed part-time as a nurse. In addition to their employment duties, the [Redacted] also operated a small “Schedule F” farming business on property adjacent to their home in Nampa, Idaho. The federal Schedule F forms attached to the [Redacted] 1996, 1997, and 1998 individual income tax returns show that they incurred a net loss of \$2,815 for 1996, \$3,252 for 1997, and \$3,464 for 1998. The depreciation schedules attached to those returns indicate that [Redacted] were raising beef cattle and sheep. Given the small amount of gross receipts listed on the Schedule F for each of the 1996 through 1998 taxable years, it appears that the operation was very small and likely only consisted of three or four animals. In any event, the information contained on the Schedule F forms appears to relate to an actual (albeit very small) farming and ranching operation. The [Redacted] did not report any Schedule F income or loss on their 1999 individual income tax returns.

In addition to the small Schedule F farming and ranching operation discussed above, [Redacted] claim that on January 1, 1997, they formed a partnership called [Redacted]. While the partnership agreement states that it was entered into on January 1, 1997, the agreement is not attested or notarized and, as a result, there is no way to verify from the face of the agreement when it was actually signed. In addition, the partnership agreement states that [Redacted] contributed \$500,000 in cash or property to the partnership in exchange for their partnership interest. Yet there is absolutely no evidence presented to the Tax Commission to suggest that

these capital contributions were actually made. In any event, according to the partnership agreement, [Redacted] has been engaged in land development and farming operations since its inception in January 1997. The business address of the partnership is listed as [Redacted]. That is also the address of [Redacted] primary home.

On or around May 8, 2001, [Redacted] filed amended Idaho individual income tax returns for the 1997, 1998, and 1999 taxable years. On those amended returns the [Redacted] claimed a loss relating to [Redacted]. The explanation provided with the 1998 and 1999 amended returns provided in part that "After the taxpayers had filed their original tax return [they] received a K-1 from their involvement in a partnership. The purpose of this amended return is to include the K-1's from the partnership and file for the resulting refund." A similar statement was provided with the 1997 amended return. While the [Redacted] claimed a loss relating to their ownership in [Redacted], no change was made to the Schedule F farm loss reported by the [Redacted] on their original 1997 and 1998 individual income tax returns.

On the same date that [Redacted] filed their amended Idaho individual income tax returns, [Redacted] filed Idaho partnership returns with the Tax Commission for the 1997, 1998, and 1999 taxable years. According to those returns, [Redacted] was engaged in farming and animal production. On those partnership returns, [Redacted] reported the following income and expenses:

	<u>1997</u>	<u>1998</u>	<u>1999</u>
Total income	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>
Repairs & maintenance	5,646	3,684	1,872
Taxes and licenses	384		
Depreciation	27,376	45,568	30,631
Other deductions	<u>24,411</u>	<u>22,990</u>	<u>23,903</u>
Total deductions	<u>57,817</u>	<u>72,242</u>	<u>56,406</u>
Net income (loss)	<u>(57,817)</u>	<u>(72,242)</u>	<u>(56,406)</u>

The partnership returns were all signed by [Redacted] as the designated Tax Matter Partner.

The [Redacted] have been unable to verify that any of the expenses claimed on the [Redacted] partnership returns were actually paid, much less that they relate to a genuine business enterprise. A closer review of the “other deductions” claimed on the partnership tax returns will help emphasize this point. For the 1997 taxable year, the partnership claimed the following “other deductions”:

Advertising	197
Bank Charges	65
Cleaning	2,213
Contributions	160
Dues	799
Entertainment	4,240
Fuel	2,410
Insurance	2,055
Office Supplies	1,110
Postage	32
Shop Supplies	1,642
Travel	4,800
Telephone	947
Utilities	1,538
Labor	<u>2,203</u>
TOTAL	<u>24,411</u>

In support of these “other deductions,” [Redacted] have provided no check register, no cash receipts and disbursement journal, and no other accounting books and records that indicate that [Redacted] paid or incurred any expenses. Furthermore, they have provided no receipts or source documents of any sort that come close to verifying that any of these claimed expenditures were actually paid. The computer-generated reports (entitled “Statement of Income and Expenses,” “Transaction Listing,” and “General Leger”) provided by [Redacted] that purport to relate to [Redacted] provide no help in verifying whether the partnership had any actual business expenses. The amounts listed on the computer-generated reports appear to relate to personal

expenses paid from [Redacted] checking account and credit cards. In any event, none of the figures listed in the computer-generated reports match up to the amounts listed as expenses on the 1997 through 1999 [Redacted] partnership returns.

Even more troubling is the depreciation expense claimed on the partnership returns. According to the depreciation schedule attached to the 1997 partnership return, the partnership owned the following assets as of the end of the taxable year:

<u>Item #</u>	<u>Description</u>	<u>Cost</u>
1.	Cabin	75,000
2.	Outbuildings	30,000
3.	Dodge	38,000
4.	94 Suburban	29,000
5.	Horses	9,000
6.	Trailer	4,000
7.	Tack	2,000
8.	Tractor	4,500
9.	4 Wheeler	6,000
10.	Snowmachine	7,000
11.	Snowmachine	1,500
12.	Boat	8,000
13.	RV	2,500
14.	Mower	800
15.	Disc	500
16.	Scrape	250
17.	Posthole digger	300
18.	Drill	250
		<u>218,600</u>

The depreciation schedule attached to the 1997 partnership return also indicated that these assets were all used 100% in the [Redacted] business operations. This claim is not credible.

The cabin listed as item 1 above is located at [Redacted]. [Redacted] is located approximately 100 miles north of [Redacted] Idaho, where [Redacted] purports to conduct its farming and ranching operations. Even more telling is that the cabin is owned as part of a time-share arrangement between [Redacted]. According to the time-share agreement entered into by the parties, [Redacted] owns a 50% interest in the cabin and is allowed exclusive use of the cabin

for twenty-six weeks per year; [Redacted] owns a 25% interest in the cabin and is allowed exclusive use of the cabin for thirteen weeks per year; and [Redacted] own the remaining 25% interest in the cabin and are allowed exclusive use of the cabin for thirteen weeks per year. More importantly, according to the purchase and sale agreement, [Redacted] purchased their ¼ interest in the cabin on August 10, 1998, for \$57,000. How this cabin ended up on the 1997 depreciation schedule of [Redacted] valued at \$75,000 is a mystery.

The two vehicles (Dodge and 94 Suburban) listed on the [Redacted] balance sheet also appear to be owned by [Redacted] and not by the partnership. According to the Idaho Department of Transportation, [Redacted] purchased a 1997 Dodge pick-up truck in August 1996, from Peterson Dodge Chrysler Jeep for \$28,339 after trade in. Prior to that, in April 1994, [Redacted] purchased a 1994 Chevy Suburban from Edmark Chevrolet for \$29,925. There is no indication in the Department of Transportation records that these vehicles have been transferred from [Redacted] to [Redacted]. In fact, the only vehicle [Redacted] has registered with the Idaho Department of Transportation is a 1997 Polaris snowmobile ([Redacted]) that was titled in the name of the partnership on December 27, 2001.

The fact that the partnership also claims that it owns two “snowmachines,” a boat, and an RV that it uses 100% in its business operations is also highly suspect. Idaho Department of Transportation records show that [Redacted] is the registered owner of several snowmobiles and a boat. In addition, [Redacted] is the titled owner of a 1975 Holiday motor home that was acquired by gift in January 2000. It is extremely doubtful that these recreational vehicles are truly owned by [Redacted] or are used in any legitimate business operation. Rather, it is obvious that most of the “assets” of [Redacted] are in reality recreational property owned by [Redacted]; some of which was not even acquired by the couple until months after it was purportedly

transferred to the partnership. In effect, [Redacted] are attempting to capitalize and expense as a business deduction their vacation cabin in [Redacted], their personal vehicles, a boat, two snowmobiles, a four-wheeler, and their 1975 Holiday motor home.

As discussed above, there is no evidence that [Redacted] is conducting any business whatsoever. Rather, the evidence before the Tax Commission clearly shows that [Redacted] created [Redacted] for the sole purpose of claiming purely personal expenditures as business expenses. As a result, the Tax Commission finds that [Redacted] is not a *bona fide* business, and that the losses claimed to have been incurred by that partnership and passed through to [Redacted] are fictitious. Furthermore, the Tax Commission finds that [Redacted] knowingly filed these false partnership returns, as well as their own amended individual income tax returns, with the specific intent to evade Idaho income tax. While the Tax Commission has not imposed the 50% fraud penalty set out in Idaho Code § 63-3046(b), that penalty is clearly warranted under the circumstances.

Idaho Code § 63-3046(b) provides that “[i]f any part of any deficiency is due to fraud with intent to evade tax, then fifty per cent (50%) of the total amount of the deficiency . . . shall be so assessed, collected and paid.” Fraud in the tax context is defined as an intentional wrongdoing on the part of the taxpayer with the specific intent to avoid taxes known to be owing. Idaho State Tax Comm’n v. Hautzinger, 137 Idaho 401, \_\_\_, 49 P.3d 406, 408 (2002). Fraud must be proved by clear and convincing evidence. Id. However, fraud may be established by circumstantial evidence and such things as understating income or overstating deductions, maintaining inadequate records, and implausible or inconsistent behavior, are all indicative of a person’s intent to evade tax. Here, the Tax Commission finds that the evidence is more than sufficient to establish that [Redacted] intended to obtain a refund of Idaho income tax that they



knew they were not entitled to by claiming false business deductions on the 1997, 1998, and 1999 [Redacted] partnership returns and on their own 1997 through 1999 amended individual income tax returns.

Fortunately for [Redacted], because their amended 1997 through 1999 Idaho individual income tax returns were not processed and their claim for a \$16,634 refund was not granted, no fraud penalty will be asserted against them for the 1997 through 1999 taxable years. However, the Income Tax Audit Division is hereby instructed to audit [Redacted] 2000 and 2001 Idaho returns as soon as practicable and, if appropriate, to assert the civil fraud penalty for those taxable years.

## **2. Other Disallowed Deductions.**

In addition to disallowing the pass-through loss from [Redacted], the Income Tax Audit Division also disallowed the Idaho medical savings account deductions claimed by [Redacted] on their 1998 and 1999 Idaho returns, and the home mortgage interest expense deduction and the charitable contributions claimed by the [Redacted] as itemized deductions on their 1998 and 1999 federal returns. With respect to their 1998 return, [Redacted] have now provided the Commission with verification that they paid \$14,548 in home mortgage interest relating to their primary home in [Redacted], Idaho. As a result, \$14,548 of the previously disallowed home mortgage interest deduction will be allowed. However, the [Redacted] have not provided sufficient evidence to support the additional medical savings account deduction that was claimed on their Idaho income tax return, and they have not provided sufficient evidence to support their claim for additional mortgage interest of \$9,065 or charitable deductions of \$550. Thus, these deductions will not be allowed due to the lack of adequate substantiation.

With respect to the [Redacted]1999 income tax return, the taxpayers have not provided adequate records to verify that they are entitled to claim an additional medical savings account deduction on the Idaho return. While the [Redacted] did provide a form MSA-1 showing that they had contributed \$4,500.82 into an Idaho Medical Savings Account and that they had earned \$2.85 in interest on that account, the copy of the MSA-1 form did not show legibly on its face that it was for the 1999 taxable year. More specifically, the box where the year is shown was totally black in the copy of the MSA-1 form provided to the Commission. The [Redacted] were asked to provide another copy of that MSA-1 form. See June 27, 2002, letter from [Redacted]. However, they have not yet provided the Commission with a clearly legible MSA-1 form showing the contributions they made during 1999. As a result, they have not adequately substantiated that they are entitled to the Idaho medical savings account deduction for the 1999 taxable year. In addition, the [Redacted] have not provided any records to verify the mortgage interest deduction or the charitable contributions they claimed as itemized deductions on their 1999 income tax return. As a result, those deductions will not be allowed due to the lack of adequate substantiation.

In conclusion, the Tax Commission will modify the July 26, 2001, Notice of Deficiency Determination by allowing the taxpayers to deduct \$14,548 in mortgage interest for the 1998 taxable year. No other modifications are warranted due to the lack of adequate records to substantiate the claimed deductions.

### **ORDER**

WHEREFORE, the Notice of Deficiency Determination dated July 26, 2001, is hereby MODIFIED and as so Modified is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the refunds claimed on the amended 1997, 1998, and 1999 Idaho individual income tax returns filed by [Redacted] are HEREBY DENIED. IN ADDITION, IT IS ORDERED that the taxpayers pay the following additional taxes, penalties, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1998	\$ 966	\$ 48	\$264	\$1,278
1999	2,545	127	512	<u>3,184</u>
			TOTAL DUE	<u>\$4,462</u>

Interest is calculated through November 30, 2002, and will continue to accrue at the rate set for the in Idaho Code § 63-3045(6)(b) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayers' right to appeal this decision is enclosed with this decision.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2002.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

#### **CERTIFICATE OF SERVICE**

I hereby certify that I have on this \_\_\_\_\_ day of \_\_\_\_\_, 2002, served a copy of the within and foregoing DECISION by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]